United States Court of Appeals

for the Second Circuit

APPELLEE’S BRIEF

75-4127

Signed

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

THE EDISON CLUB,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court correctly determined that no portion of the receipts derived by taxpayer, a nonexempt social and recreational club, from its members during the years in question is excludable from income as a contribution of capital.

STATEMENT OF THE CASE

This appeal involves deficiencies in federal income taxes determined by the Commissioner to be due from the Edison Club (hereinafter taxpayer) in the amounts of $4,630.48 and $18,537.72, respectively, for its taxable years ending March 31, 1967, and March 31, 1968, and an addition to tax determined to be due under Section 6651(a) of the Internal Revenue Code of 1954 (26 U.S.C.) of $463.05 for the taxable year ended March 31, 1967. (R. 216.)[1/] Taxpayer filed a petition in the United States Tax Court for redetermination of these deficiencies on November 22, 1971. (R. 4.) The memorandum findings of fact and opinion of the Tax Court (Honorable William H. Quealy), which are unofficially reported at 34 T.C.M. 79 (1975), were filed on February 6, 1975. (R. 153.) The decision of the Tax Court sustaining the deficiencies as determined by the Commissioner, was entered on March 14, 1975. (R. 216.) Taxpayer timely filed its notice of appeal on June 3, 1975. (R. 217.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The relevant facts, as found by the court or as otherwise appear in the record, may be summarized as follows:

Taxpayer was, during fiscal 1967 and 1968, a non-stock social and recreational club organized under the Membership

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1/ "R." references are to the separately bound record appendix; "Ex. Vol." references are to the Exhibit Volume.

Corporation Law of New York, and operating in Rexford, New York. (R. 154-155.) The club had several classes of membership: regular, associate, house, women, pool, and junior #1, junior #2, and junior #3. (R. 156.) Pursuant to its constitution, ownership of the club was vested in the regular members. Likewise, only regular members could vote or hold office. Regular membership was restricted to employees of General Electric Company. (R. 156.) While it was operated primarily for the benefit of members, taxpayer also derived substantial income from the use of its facilities by nonmembers. (R. 155.) In late 1965, taxpayer was advised that the Commissioner had determined that it failed to qualify as a tax-exempt organization under Section 501(c)(7) of the Internal Revenue Code of 1954 for years subsequent to March 31, 1959, and taxpayer concedes that it was a taxable entity subject to the federal income tax for the years in question. (R. 168).

In addition to its receipts from the sale of food and beverages and from the rental of its facilities, taxpayer derived funds from initiation fees and annual fees, dues and assessments collected on a monthly basis from members. Under taxpayer's constitution and bylaws, the power to establish initiation fees, dues and annual assessments (up to $100 for each member) was vested in its board of directors. (Ex. Vol. 41, 43-44.) No restriction was placed on the purposes for which such membership assessments could be made by either the

constitution or by the bylaws. (Ex. Vol. 39-45.) Once made, such an assessment was required to be paid within 12 months of notice of assessment. (Ex. Vol. 44.)

For certain years prior to the years here in issue (taxpayer's fiscal years ending March 31, 1967 and March 31, 1968), the schedule of dues and fees adopted by taxpayer's board of directors had provided for a charge designated as an "assessment," the purpose of which was to provide funds for capital improvements and to obtain the benefit of the exemption which was provided by Section 4243(b) of the Internal Revenue Code of 1954 in the case of payments for capital improvements from the excise tax formerly imposed by Section 4241 of the Code, which was repealed effective January 1, 1966 (Excise Tax Reduction Act of 1965, P.L. 89-44, 79 Stat. 136, Sec. 301) on dues and fees collected by social, athletic and sporting clubs. (R. 156-160.) Thus, for example, the monthly charge to members for its fiscal year beginning April 1, 1965, was broken down among the three categories (1) "Dues," (2) "Excise tax on dues," and (3) Assessment." (R. 162, 165-166.)

At the same time the dues structure for taxpayer's fiscal year 1966 was approved, the board considered a proposal for increasing the total monthly charge for the following year, the minutes of the meeting reflecting that such an increase would be necessary to permit the contemplated purchase of the club's facilities from the General Electric Realty Corporation,

which then held title to the property. (R. 163.) The minutes concluded, however, as follows (R. 163):

> The final determination of the dues structure * * * will of course be the decision of the existing Board of Directors in February, 1966.

Apparently, pursuant to this proposal, the letter of March 8, 1965, from the club's president to its members enclosed, in addition to the dues structure adopted for the fiscal year 1966, a "Proposed Dues Structure" for the fiscal year 1967, which, again broke the proposed total monthly charge down into three components (Dues, Excise tax on dues, and assessment) but reflected a proposed $3 per month increase in the "Dues" portion of the monthly amount. (R. 165-166.) However, the record does not indicate that this proposed dues structure was adopted by the board of directors for the fiscal year 1967, or that the board of directors ever adopted any assessment for capital improvements for either of the years in question.

Following the repeal of the excise tax on dues, the board of directors authorized the opening of a special savings account to be used for the deposit of the club's "excise tax savings" resulting from the repeal of the tax, with such funds to be used for the down payment required on the aforementioned purchase of the club's facilities. (R. 168.) An initial deposit of such "excise tax savings" was made in the amount of $5,502.[2/] (R. 169.) Thereafter, during the two years in issue, additional deposits

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2/ The Tax Court noted (R. 169, fn. 5) that it was unable to determine from what account this sum was derived.

to this account were made in the amounts of $43,109.95 and $39,396.31, and, on March 31, 1968, $70,000 was withdrawn from this account for the purpose of making the down payment on the club property. (R. 179, 189.)

During taxpayer's fiscal year 1967, the first of the two years in issue, taxpayer's members were billed on the basis of the same total monthly charges provided for under the dues structure for the prior year. The record fails to disclose that the board of directors approved such schedule for such year or that it ever advised the members that any portion of the monthly charges included a contribution to capital or assessment for capital improvements or for the purchase of the club property. (R. 170.)

The minutes of the meeting of taxpayer's board of directors when the schedule of dues and fees for fiscal 1968 was adopted (which schedule would normally have included any assessment made) were not put in evidence. The minutes of taxpayer's board of directors meeting of February 23, 1967, states (R. 172):

> Dues Structure
>
> After careful consideration of the higher operating costs of the Club, the decrease in membership and the lower net income from the Restaurant operation, Schedule "D" of the dues structure was accepted by the Board. A letter shall be drafted and sent to the members explaining the reasons for the dues increase.

The letter mentioned in the minutes (R. 173-174) was sent to the members, dated March 9, 1967. The letter stated that the dues for fiscal 1968 were identical to the dues schedule which had been proposed in 1965 (but not adopted) for fiscal 1967. (R. 174.) However, neither the letter nor the dues schedule enclosed therewith (R. 175) indicated that the total monthly charges included any special purpose assessments. Instead of the three categories into which the total monthly payments had been divided on the proposed schedule for fiscal year 1966 (R. 166), the "Total Dues" on the schedule adopted for fiscal 1968 were broken down into only two categories: (1) "Dues" (in a monthly amount equal, in most cases, to the total monthly charge shown on the proposed schedule for fiscal year 1966), and (2) an additional charge designated "St. Tax" (R. 175). While the letter indicated that the dues structure was designed to permit the board to initiate major improvement programs and to accumulate funds for the purchase of the club's facilities, as well as to maintain facilities and equipment and meet scheduled cost increases (R. 173-174), the members were not advised that any particular portion of the monthly charges would be specifically allocated to any of these purposes. Indeed, the minutes of a board meeting held on October 12, 1967, indicated the amount of each member's total dues for the fiscal year ending March 31, 1968, which was to be used for capital improvements had not yet been determined (Ex. Vol. 68), and, as of January 11, 1968, the members still

had not been informed as to what portion of the total dues was to be used for capital improvements (Ex. Vol. 70).

During the tax years at issue, taxpayer continued to credit the same amounts of receipts from members to the "Assessments" account as it had in prior years despite the apparent lack of any board action approving assessments for capital improvement, for such years.[3/] (R. 180.) The amounts credited to the "Assessments" account during fiscal 1967 and 1968 ($38,925.48 and $38,354.82, respectively (R. 180)) were not accounted for as capital contributions on the books of the taxpayer for the relevant years. Rather, the amounts credited to the Assessments account were lumped with all other receipts. Total expenses were subtracted from these receipts to reach the year's "Profit & Loss" figure. The "Profit & Loss" account for the year was then closed out to "Surplus." (R. 180A-182.) This "Surplus" account was carried under the heading "Club Equity" on the balance sheets for the relevant taxable years. (R. 183-184.) Prior to the annual meetings of the taxpayer's members in December of 1966 and 1967, the members were furnished with an "Operating Statement" of the club for the seven months of the respective fiscal year between April and November. (Ex. Vol. 81, 83.) In each case that Operating Statement lumps assessments and initiation fees together. Initiation fees were considered by taxpayer as income not capital items (Ex. Vol. 1, 3, 13, 17), and the aggregate figure was treated as an income item.

3/ This account was later redesignated as "Capital Improvements," but the Tax Court found this charge nomenclature was not adopted until after the period here in question. (R. 178.)

In computing the deficiencies for the years in question, the Commissioner determined that all of taxpayer's receipts from members were includable in its gross income, including the amounts credited on its books to "Account No. 501 Assessments" which taxpayer contended were excludable from income on the theory that such amounts constituted contributions to capital under Section 118 of the Internal Revenue Code of 1954. (R. 188-189.) The Commissioner also determined that a penalty was due under Section 6651 of the Code on account of the club's failure to file a timely return for its fiscal year 1967. (R. 190.) The Tax Court concluded that taxpayer had failed to establish that the amounts in question had been assessed by the board and paid by the members for the specific purpose of making capital improvements and that the cases relied on by taxpayer for the proposition that such amounts could be treated as nontaxable contributions to capital were inapposite in this case. (R. 190-204.) It also concluded that the penalty should be sustained since taxpayer failed to introduce any evidence to show reasonable cause for its failure to file its 1967 return on time. (R. 204-206.) After the court's findings of fact and opinion were filed, taxpayer filed a document purporting to be a proposed "Computation for Entry of Decision" in which it asserted an alternative argument that it should be entitled to exclude from gross income that portion of its asserted capital expenditures for the years in question which bears the same proportional relationship to total capital expenditures as its

asserted "member assessments" bore to the club's combined "net income" and "member assessments."[4/] (R. 209-212.) The court rejected this contention, holding that, under its findings of fact and opinion, all taxpayer's receipts from members "constituted gross income in the first instance," and, therefore, that there was no basis for excluding any portion of such receipts or taxpayer's capital expenditures from taxable income. (R. 215.) The court thereupon entered a decision sustaining the deficiencies as determined by the Commissioner (R. 216) and taxpayer appeals.[5/]

SUMMARY OF ARGUMENT

The accepted general rule is that a nonexempt country club such as taxpayer is subject to income tax on its income from all sources, including dues, fees, and assessments received from members. On the other hand, of course, as in the case of any other type of corporation or taxable association, such

4/ In applying this formula (R. 210-211), taxpayer treated the amounts credited to its "Account No. 501 Assessments" as "member assessments," its reported net income (excluding such asserted "member assessments") as "net income," and the sum of the following amounts as "capital expenditures" for each year:

(1) the amounts shown as expenditures on its "Plant and Equipment" account (R. 180),

(2) the amounts credited on such account for the "retirement of capital assets" (R. 180), and

(3) the amounts placed in the special savings account for the purchase of the club property (R. 179).

5/ While taxpayer challenges the decision both as to the deficiencies in taxes for the years in question and the penalty for 1967, it concedes (Br. 2) that the resolution of the principal issue will be determinative as to its liability for the penalty.

clubs may exclude from gross income receipts qualifying as contributions to capital under Section 118 of the Internal Revenue Code of 1954, and it has been held, in the case of membership corporations, that amounts specifically assessed and paid by members for the purpose of acquiring capital improvements (such as swimming pools, clubhouses, and the like) may qualify as such contributions to capital. Taxpayer, in challenging the Commissioner's determination on the basis of such decisions, had the burden of proving that the amounts at issue were, in fact, capital contributions rather than taxable income. This, it was unable to do.

Under taxpayer's constitution and bylaws, the board of directors could pass an assessment for any purpose, but no assessment could be outstanding more than one year. While it had apparently adopted capital improvement assessments in certain prior years, the record does not show the terms or purposes of the purported assessments for the taxable years here at issue, or, indeed, that any special assessments for any purpose were ever adopted by the board for such years. The dues structure as described for the members of taxpayer for fiscal 1968, simply does not mention any assessment nor did the accompanying letter. And, for neither year were minutes of board meetings introduced to show any exercise of the board of its power to impose special board capital improvement assessments on the members. At best, the record shows that one of the directors somehow understood that the club was proceeding on the same basis as before, and that

the members had been advised, at least for fiscal year 1968, that the club would be using the funds collected from them for capital improvements as well as to defray operating expenses. Such evidence clearly does not support the conclusion that any particular part of such receipts from members were specifically assessed and paid for the purpose of acquiring capital improvements.

Nor is there any showing that taxpayer treated the amounts in question as contributions to capital on its own books and records. Rather, taxpayer's accounting records for the two years at issue show a consistent pattern of treating purported assessments, together with the rest of the dues and fees received from members, as <u>income</u> rather than capital items. Thus, these amounts ultimately were reflected in the computation of taxpayer's surplus, not as additional paid-in capital.

Likewise, the lower court correctly rejected the alternative argument, first advanced by taxpayer on its proposed computation for entry of decision, that it should be entitled to deduct a portion of its actual capital expenditures during the years in question. In the first place, that argument raises factual questions as to the actual amount of its capital expenditures for these years which were not properly raised before trial and which are not subject to resolution on the record here. More significantly, however, this alternative contention is legally unmeritorious in light of the findings and conclusions of the Tax Court to the effect that taxpayer failed to establish

that any portion of the receipts from members was assessed and paid as a contribution to capital. If these receipts were not contributions to capital in the first instance, they could not be transformed into such contributions to capital simply by virtue of the club's subsequent use of such funds for capital expenses. Given the fact that Congress has specifically provided, in Section 263 of the Code, that no deduction shall be allowed for capital expenditures (and has provided no special relief from such provisions in the case of nonexempt social clubs), it would indeed be highly anomalous if general receipts from members could be rendered nontaxable simply by virtue of the taxpayer's use of such funds for making capital improvements.

Taxpayer cites and argues numerous cases to this Court as he did to the Tax Court. The basic failure of taxpayer, as noted by the trial court, is that the cases on which he relies simply are not factually analogous since they involved funds which were treated by the recipient as capital contributions. In view of the failure to carry the burden of proof, the Commissioner's determination was properly affirmed.

ARGUMENT

THE TAX COURT CORRECTLY DETERMINED THAT NO PORTION OF TAXPAYER'S RECEIPTS FROM MEMBERS WAS EXCLUDABLE FROM INCOME AS A CONTRIBUTION OF CAPITAL

Taxpayer, in its opening brief raises claims of errors almost too numerous to be digested and analyzed. That brief includes what taxpayer refers to as a "paragraph-by-paragraph analysis of the Tax Court's opinion," the asserted purpose of which is to show how "the Tax Court distorted the facts." (Br. 34.) Rather than reply seriatim to taxpayer's sometimes rather shrill arguments,[6/] we will focus our brief on the one point which we believe to be dispositive--taxpayer's failure to carry its burden of proof. Taxpayer does not provide any clear recitation of how it believes it carried its burden[7/] of proving the Commissioner's determination of deficiencies to be incorrect in this case. Indeed, it could not do so, for the vast majority of the evidence favors the Commissioner's determination which the Tax Court upheld.

The general rule is that a social club, unless exempt from the income tax under Section 501(c)(7) of the Internal Revenue Code of 1954 (26 U.S.C.), is taxable on income from <u>all</u> sources, including dues, assessments, or other membership fees.

6/ See, e.g., Brief, page 38, where the taxpayer claims the Tax Court's opinion is so rambling and incohesive as to amount to a denial of due process and Brief, page 40 where we read the last sentence to accuse the Tax Court of intentionally misrepresenting the facts of this case.

7/ See <u>Welch</u> v. <u>Helvering</u>, 290 U.S. 111, 115 (1933), <u>Flomarcy Co.</u> v. <u>Commissioner</u>, 324 F. 2d 730 (C.A. 2, 1963).

United States v. Fort Worth Club of Fort Worth, Texas, 345 F. 2d 52, 57 (C.A. 5, 1965), modified on rehearing 348 F. 2d 891 (1965). The prima facie inference is that payment by members, to a membership organization which organization provides facilities and services to the members, are made with a view to, and in consideration for, services, and the privilege of using such facilities. See United Grocers, Ltd. v. United States, 186 F. Supp. 724, 736 (N.D. Cal., 1960), aff'd, 308 F. 2d 634 (C.A. 9, 1962). In this case taxpayer asserted, contrary to the Commissioner's notice of deficiency (R. 9-10) and explanation thereof (R. 11-13), that a portion of its receipts from members constituted a nontaxable capital contribution within the meaning of Section 118, Internal Revenue Code of 1954 (26 U.S.C.).8/ Taxpayer's counsel at the trial acknowledged that taxpayer had the burden of showing that the purported assessments were in fact capital contributions and not payments for services. (R. 77.) See Treasury Regulations on Income Tax (1954 Code), Section 1.118-1 (26 C.F.R.). Taxpayer failed to carry the burden.

Basically, taxpayer's contention is that certain receipts from members, called assessments, and credited to an account formally entitled "Account No. 501-Assessments" (R. 180) are capital contributions and therefore nontaxable. The flaw with

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8/ Section 118, which has no counterpart in previous law is a codification of judicial and administrative decisions exempting capital contributions from taxation. See S. Rep. No. 1622, 83d Cong., 2d Sess., p. 190 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4825).

this argument is that its underlying premise--i.e., that a specific part of its receipts from members was actually assessed and paid as a special assessment for capital improvements--simply is not supported by the record. The authority to enact the purported assessments here at issue, was, under taxpayer's constitution and bylaws, placed with the board of directors. (Ex. Vol. 44.) The board was authorized to enact an assessment for any purpose (Ex. Vol. 44), and in years prior to the taxable years here at issue, assessments had been made, at least in part, for noncapital expenditures (R. 199-200). Assessments were required to be paid within 12 months (Ex. Vol. 44), and the board of directors for a particular fiscal year controlled assessments enacted for that year (Ex. Vol. 44). Thus, evidence which indicates that assessments in other years might have been capital contributions could, at most, corroborate the evidence introduced with respect to the particular tax years at issue. Such evidence could not, by itself, carry the taxpayer's burden with respect to the years at issue.

There is no evidence in the record that the purported special capital improvement assessments for fiscal 1967 and 1968 were ever passed by the board of directors for those two years, nor was there any evidence as to what the terms or purposes of any special asessments might have been or, indeed, who was assessed. The record contains no dues structure for fiscal 1967, such as was provided to the members in prior years (Ex. Vol. 25-28, 88, 94), setting forth in detail dues,

assessments, and excise taxes to reach a total figure. Nor does the record show that members were ever informed that any particular portion of dues or assessment for 1967 was specifically dedicated to capital improvements. (R. 170, 202.) For fiscal 1968, a statement of the dues structure (R. 175) was provided to the members, but such schedule contain no reference whatsoever to assessments, nor does the accompanying letter (R. 173-174). Indeed, the minutes of the taxpayer's board of directors during fiscal year 1968 indicate that by the middle of the fiscal year, the board still had not determined what portion of dues [9/] would be devoted to capital; indeed, at the annual meeting January of 1968, near the end of such taxable year, taxpayer still had not informed the members as to this matter. (Ex. Vol. 68, 70).

The Tax Court was also correct in rejecting as irrelevant proffers of one individual board member's personal understanding as to the purpose of the assessment in the "Proposed Dues Structure To Be Effective 4/1/66" (R. 166), which was never, in fact, adopted (R. 169-170), and whether the dues structure for fiscal 1968 (R. 175) which did not even mention assessments, was nevertheless understood by such director to include an assessment (R. 131-132, 133). Likewise, hearsay testimony relating to what other individuals might have said to that director as to their own understanding about assessments

9/ The word dues, as used by taxpayer, in the dues structures of various years often included both dues and assessment. (Ex. Vol. 25-28, 88, 94.)

was also properly rejected by the court. (R. 138.) The matter at issue turned on what the board of directors did, not the beliefs of individuals as to the unstated intentions of the board. While, the underlying facts upon which those beliefs were based might have been relevant, such facts were not offered in evidence. There was thus simply no basis for the Tax Court to find that a special capital improvement assessment was ever imposed on the members for either of the years in issue.

Clearly, this failure of proof as to the actual imposition of any special purpose assessments during the years in question is not overcome by the evidence as to the fact that taxpayer's bookkeeper and office manager continued to reflect a portion of the receipts from members in an account labeled "assessments" or the fact that the club generally used such funds for capital expenditures. There is plainly no basis in the statute for holding that general membership receipts which are not capital contributions in the first instance can become excludable from taxable income because the taxpayer therafter decides that a portion of such receipts be set aside and used for capital purposes. The Tax Court's liberal construction of Section 118 to encompass within the term "contributions to capital," a membership corporation's special capital improvement assessments collected from its members (see, e.g., Minnequa University Club v. Commissioner, P-H Memo T.C., par. 71,305 (1971)) might be

deemed justifiable (notwithstanding the fact that Section 118 wasn't adopted with such assessments in mind),[10/] Congress has specifically provided that capital expenditures are not deductible, and it would clearly fly in the face of these provisions to hold, as taxpayer suggests (Br. 15-16), that the mere fact that a membership corporation chooses to use part of its general receipts from members for capital purposes would serve as a basis for excluding such funds from taxable income when, in fact, no specific portion of such receipts was specially assessed and paid for capital purposes.

By the same token, taxpayer's position is not supported by the fact that a certain portion of its receipts were set aside in a special bank account to be used for making the down payment on the purchase, from General Electric Realty Corporation, of the club property. Absent a showing that such funds were collected pursuant to a special assessment for such purpose, there is simply no basis for excluding such funds from taxpayer's gross income. Indeed, the relationship between the amounts placed in this savings account and the amounts sought to be excluded here as capital contributions is rather obscure. To be sure one of taxpayer's employees testified at trial (R. 62, 66-67) that the amounts credited to the "assessments" account were transferred from the taxpayer's general checking account

10/ See H. Rep. No. 1337, 83d Cong., 2d Sess., p. 17 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4041-4042) the pertinent portions of which are set forth in the Tax Court's opinion. (R. 192.)

to a special savings account reserved for capital purposes. But this testimony is contrary to the minutes of the meeting of taxpayer's board of directors on February 10, 1966 (R. 169), which provides that deposits in that particular account would not be derived from receipts designated as "assessments" on the dues schedules for 1966 and prior years, but would be, "limited to savings on the Excise Tax on Club Dues and Initiation Fees only." (Emphasis added.) Moreover, taxpayer concedes on brief (Br. 39) that the deposits in the savings account did not correspond to the credits to "Account No. 501-Assessments" and that this discrepancy was unexplained at trial. Taxpayer points to no facts or testimony explaining the discrepancy but simply suggests (Br. 39) that it "may be" explained by confusion in taxpayer's accounting department. The discrepancy might also be explained by the different hypothesis that, for the years at issue, there was, in fact, no relation between the credits to the assessments account and the deposits in the savings account. Since the record does not contain sufficient evidence to sustain or reject either hypothesis, taxpayer is attempting to meet its burden of proof with conjecture, not fact.

Moreover, even accepting, arguendo, the assertion that the fact that the amounts in question were reflected on taxpayer's books in an account designated "assessments" and the fact that taxpayer's financial statements spearately stated amounts received as "initiation fees and assessments" could show that

amounts collected from members included both regular dues and a special purpose assessment (notwithstanding the fact that, for one of the years involved, the total amount was designated "dues" (R. 175)), the Tax Court correctly noted (R. 199) that the record fails to show that such amounts were enumerated for any specific purpose. And, indeed, viewing taxpayer's overall accounting treatment of its membership receipts, it is clear that taxpayer treated the purported assessments as items of income, not capital contributions. On the part year operating statements provided members prior to the annual meetings for the tax years at issue (Ex. Vol. 80-83), taxpayer treated the purported assessments as a component of "Total Income" (Ex. Vol. 81, 83). On these operating statements "Total Expenses" were subtracted from "Total Income" to arrive at "Net Income" (Ex. Vol. 81, 83). The purported assessments are lumped with initiation fees, under the category "Initiation Fees and Assessment" (Ex. Vol. 81, 83) on the operating statements. Taxpayer clearly understood the initiation fees to be ordinary income during the years at issue. (Ex. Vol. 1, 3, 13, 17.) The aggregation of the two categories of receipts on the operating statements is indicative that taxpayer likewise understood the purported assessments to be income items and not capital contributions. Indeed, the very inclusion of a capital contribution on an operating statement would be anomalous from an accounting standpoint, as a capital contribution has nothing to do with operations.

Similarly, on taxpayer's Statements of Revenue and Expenses for the two tax years at issue (R. 184, 187), the purported assessments are included as a revenue item in the calculation of "Net Income." On the Statement of Revenue and Expenses for fiscal 1968 (R. 187) only one figure appears under the category "Club Dues & Assessments." Such treatment once again indicates that taxpayer understood the purported assessments to be income items, of the same nature as dues, and not capital contributions. To be sure, a taxpayer's own financial accounting methods may not precisely correspond with the accounting treatment required for tax purposes. But, while perhaps not conclusive, taxpayer's repeated accounting treatment of the purported assessments as income and not as capital contributions is strong corroborative evidence that the purported assessments were not actually intended as capital contributions. See this Court's opinion in West Side Tennis Club v. Commissioner, 111 F. 2d 6, 9 (1940), cert. denied, 311 U.S. 674 (1940), and the opinion of the Board of Tax Appeals in the same case, 39 B.T.A. 149, 159-160 (1939), both of which rely in part on the accounting treatment of purported capital contributions to deny a exclusion with respect to a private club's receipts from members. Given the evidentiary shortcomings of taxpayer's case, it becomes clear that the Tax Court was correct in concluding (R. 194) that taxpayer had not shown that its case was factually within the ambit of the law enunciated

in the cases upon which taxpayer relies. The case of Minnequa University Club v. Commissioner, supra, is clearly distinguishable. There, the club had levied a special assessment for the sole purpose of repairing and improving its facilities. There, the Tax Court stated (p. 71-1376):

> That the assessed amounts were received by petitioner as contributions to its capital is clear. The terms of the assessment limited the use to be made of the funds. The funds were always maintained and accounted for separately; and, lastly the funds were actually expended on capital expenditures.

No such "ear marking" was established in this case. The terms of the purported assessment are not in evidence, the funds collected were commingled with taxpayer's other receipts (R. 177) and for accounting purposes, the purported assessment receipts were, on occasion, combined with other, ordinary income items (R. 187; Ex. Vol. 81, 83). Indeed, it is unclear from the record that the funds collected under the purported assessment were actually used solely for capital expenditures.11/

11/ Underlying the Tax Court's rationale in Minnequa University Club was its conclusion (p. 71-1376) that the club's members were, in effect, its owners and stockholders, notwithstanding their lack of a transferable interest. Here, that rationale would appear to apply only to the regular members, who had exclusive voting rights and in whom the club's constitution vested the rights of ownership. (R. 156; Ex. Vol. 39, 41.) As taxpayer notes (Br. 18), Section 118 also applies to contributions from non-shareholders, but it does not apply to payments made in consideration of direct benefits expected as a result of such payments. Teleservice Co. of Wyoming Valley v. Commissioner, 27 T.C. 722 (1957), aff'd, 254 F. 2d 105 (C.A. 3, 1958), cert. denied, 357 U.S. 919 (1958). Plainly, even assuming a special capital improvement assessment had been levied in this case, payments by taxpayer's non-regular members could not qualify under Section 118 on this basis since they were quite obviously paid in consideration of the privilege of using the club facilities.

Nor is taxpayer's position here supported by the Tax Court's memorandum decision in Lake Petersburg Assn. v. Commissioner, P.H. Memo T.C., par. 74,055 (1974). That case involved the taxability of funds which the court found were assessed and collected from members for the purchase of land and which it found were "adequately earmarked" for such special capital purposes. In reaching this conclusion, the court noted (p. 74-245) that, the "revenues received by petitioner from its members in respect of assessments on the lakefront lots were characterized on petitioner's balance sheets as capital items and were not recorded or taken into account as income items," and (p. 74-251) that "Petitioner's representatives informed applicants for membership in petitioner that the assessments would be accumulated to be used for the purchase of the land and the erection of various improvements on the land." Thus, in the Lake Petersburg Assn. case, supra, both the terms the assessment and the accounting treatment of assessment receipts supported a theory of capital contribution.12/ This is not the case here. Similar distinctions with respect to proven terms

12/ Nor is there any basis for taxpayer's contention (Br. 25-26) that the Lake Petersburg case supports an "expenditures theory" as to the application of Section 118. In fact, as taxpayer concedes (Br. 25), the Tax Court based its conclusion on its finding that such amounts had been specifically assessed and earmarked for capital purposes from the outset. Simply because the result reached might also have been reached under any of a number of broader rationales, does not, as taxpayer contends (Br. 25), mean that the decision actually "supports [such] a broader conclusion." Thus, in no way can that decision be read to support the proposition advanced by taxpayer that assessments can be excluded up to the amount of capital expenditures without regard to whether such funds were specifically assessed and collected for such purposes in the first instance.

of assessments or accounting treatment exist between the case at bar and the cases of 874 Park Avenue Corp. v. Commissioner, 23 B.T.A. 400 (1931) and Cambridge Apartment Building Corp. v. Commissioner, 44 B.T.A. 617 (1941).

Finally, taxpayer relies on a so-called "allocation theory" to justify the exclusion from income of part of its capital expenditures under Bear Valley Mutual Water Co. v. Riddell, 283 F. Supp. 949 (C.D. Calif., 1968), aff'd, 427 F. 2d 713 (C.A. 9, 1970), rev'd on other grounds, 493 F. 2d 949 (C.A. 9, 1974). (Br. 26-27, 41, 58.) This argument was first raised after trial below in taxpayer's proposed "computation for entry of decision" (R. 209-212), in which it argued that actual capital expenditures should be allocated between member assessments and other income, and that the amount allocated to member assessment should be allowed as an exclusion from gross income according to the following formula:

$$\frac{\text{Member Assessments}}{\text{Member Assessments + Net Income}} \times \begin{array}{c}\text{Capital}\\ \text{Expenditures}\end{array} = \begin{array}{c}\text{Amount to be}\\ \text{Excluded from}\\ \text{Gross Income}\end{array}$$

In the first place, to the extent this argument raises factual issues as to the amount of capital expenditures to be taken into account under this formula which were not squarely presented under the pleadings (R. 4-7), and the theory upon which the case was tried (R. 24-25), this alternative contention was not timely raised below. See, e.g., Shomaker v. Commissioner 38 T.C. 192, 201 (1962). To be sure, the figures taxpayer would use in this

formula (R. 210-211) are all found in the Tax Court's findings, but that is not to say that their use would actually be supported by such findings. For example the "capital expenditures" figures used by taxpayer would include the amounts found to have been placed in its savings account (R. 179), rather than the amount actually used from such account in purchasing the club property. The capital expenditures figures also include the amounts shown as debits for capital expenditures or additions on its "plant and equipment" account (R. 180), though there is really no showing that such amounts were actually expended for capital improvements. And, finally, taxpayer would include in its "capital expenditures" the amounts shown as credits to that account for retirement of capital assets. (R. 180.)

In any event, we submit that the court below correctly rejected the application of such an "allocation" formula in this case even assuming, arguendo, that this alternative argument had been timely raised and the amount of taxpayer's capital expenditures had been definitely established. In the first place, to the extent that the Bear Valley case and the Lake Petersburg case, supra, might be read as allowing an exclusion for membership receipts simply on the basis of how the club uses such receipts, they are plainly erroneous. As the Tax Court concluded (R. 215), if the receipts cannot properly

be treated as capital contributions in the first instance, there is no basis under the statute for allowing an exclusion for any portion of such receipts based on the club's subsequent use of these funds. Moreover, the Bear Valley case no more supports such a broad proposition than does the Lake Petersburg case--see fn. 12, supra. While we do not subscribe to the District Court's conclusions in Bear Valley, that case, too, is distinguishable from the instant case in that the special assessment there in question was found to have been imposed by a mutual water company on its stockholders not as the price for furnishing water, but, rather, for acquiring funds for two specific purposes: (1) to cover the deficit in operating expenses for the year and (2) to use the balance for capital expenditures. 283 F. Supp., p. 958. Noting that the assessment would, to the extent imposed for the later purpose, constitute a nondeductible capital expenditure on the part of the stockholders, the court concluded that it should, to such extent, also be treated as a receipt of a capital contribution by the company. 283 F. Supp., pp. 959-960. We doubt the propriety of the court's formulary approach to determine, by reference to subsequent events, the amount to be treated as a capital contribution. 13/ Here, however, taxpayer

13/ In its short per curiam opinion affirming the judgment of the District Court, the Ninth Circuit made no reference to the assessment issue, but rather, simply affirmed on the basis of Anaheim Union Water Co. v. Commissioner, 321 F. 2d 253 (C.A. 9, 1963), a case which did not involve such an assessment question, but which dealt solely with the other questions presented in Bear Valley.

does not seek to use such a formula simply for the purpose of quantifying the portion of an assessment intended, in part, as a capital contribution in the first instance. As we have shown above, unlike the taxpayer in Bear Valley, taxpayer here failed to establish (1) that the board of directors had in fact imposed a special assessment for the years in question or (2) if such an assessment was imposed, what the specific purposes of such assessment might have been. In short, there was no basis for concluding that, to whatever various uses taxpayer might devote such funds, the receipts in question were paid for any specific purpose other than for the services provided by the club and the annual privilege of using the club's facilities. Since they were not in fact paid specifically for the purpose of acquiring capital improvements, or augmenting the club's capital structure, the taxpayers subsequent use of such funds cannot serve to generate an exclusion. See Section 1.118-1 of the Treasury Regulations on Income Tax. Cf. United States v. Chicago, B. & Q. R. Co., 412 U.S. 401, 412-413 (1973).

CONCLUSION

For the reasons appearing above, the decision of the Tax Court should be affirmed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 10th day of November, 1975, in an envelope, with postage prepaid, properly addressed to him as follows:

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